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Compass

3rd Quarter 2020

The world under the spell of the virus

Long-term consequences of a pandemic

Investment opportunities in times of pandemic

Your wealth, our responsibility.

Investing in times of pandemic

Financial markets were still celebrating the US-China trade deal when coronavirus spoiled the party abruptly. Within weeks, markets tumbled 35% as lockdowns forced businesses across Europe and the US to shut down. This time central banks did not hesitate, but faced the potentially devastating economic consequences and dove deep into their arsenal of monetary policy. Investors assumed a “Don’t fight the Fed” approach and financial markets recovered. The real economy, however, will not recover so quickly, as global growth is likely to be negative for 2020. How quickly the economies will return to pre-covid19 levels will depend on the effectiveness of health, fiscal and monetary policies taken to respond to this pandemic. Regardless of what happens, countries globally will come out of this with more public debt, which was either directly (e.g. UK) or indirectly (e.g. Eurozone) financed by central banks. In contrast to post-war times, pandemics, however, do not require much reconstruction. Therefore, demand for capital expenses should remain low. This, combined with a high saving rate, should lead to falling real interest rates. Moreover, fear of job losses following the pandemic could increase the saving rate further and the US in April 2020 experienced the highest rise in unemployment rates ever. The final part of this Compass, “Knowledge & Experience“, is dedicated to the opportunities presented to investors in such unprecedented times. The focus here lies on defensive equities, inflation-linked US government bonds and gold. Gold being the best-performing asset class to date this year.

Maintaining a slightly defensive positioning

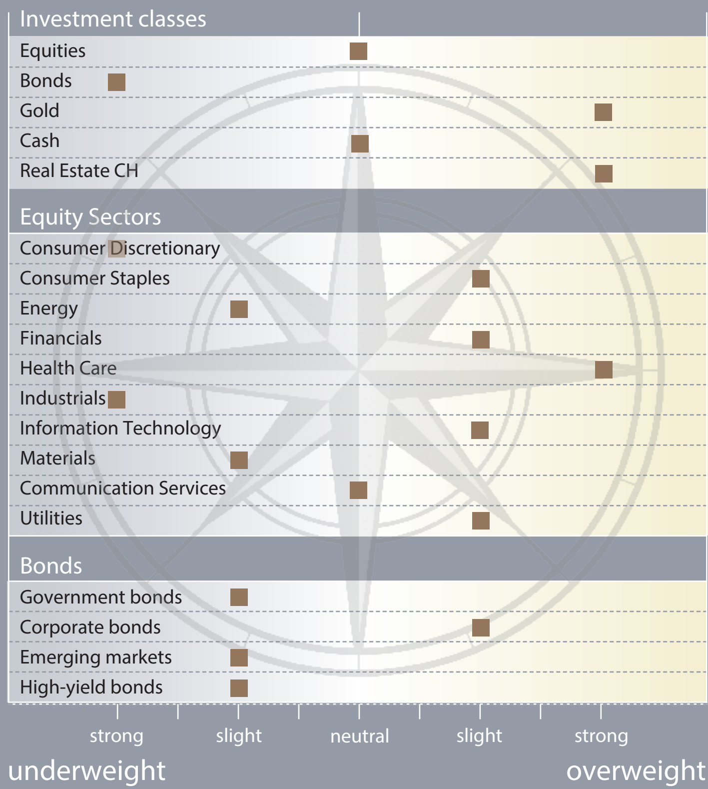
Given the current uncertainty about the further course of the pandemic, we are maintaining our slightly defensive positioning.

At the asset class level, we remain neutral on equities, but cautious within the sector allocation. Low real interest rates lead us to be underweight bonds in favour of Swiss real estate and gold.

Within equities, we prefer the defensive sectors of consumer staples, healthcare and utilities. We maintain a clear underweight in the cyclical sectors consumer discretionary and industrials. We also favour financials, especially insurance companies over banks, and information technology stocks. These slightly overweighed sectors are at the expense of the energy and commodities sectors.

In the bond sector, we continue to favour corporate bonds over government bonds. We maintain our slightly underweight position towards emerging market bonds and high-yield bonds.

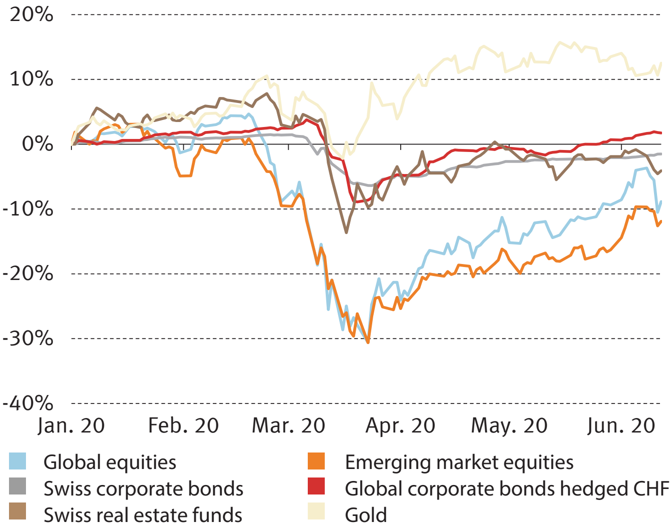
Asset allocation recommendation as of June 23rd, 2020 for investors with CHF as their reference currency.



Basic Trend:
The world under the spell of the virus

Basic Trend 1:

Total return (net) in CHF

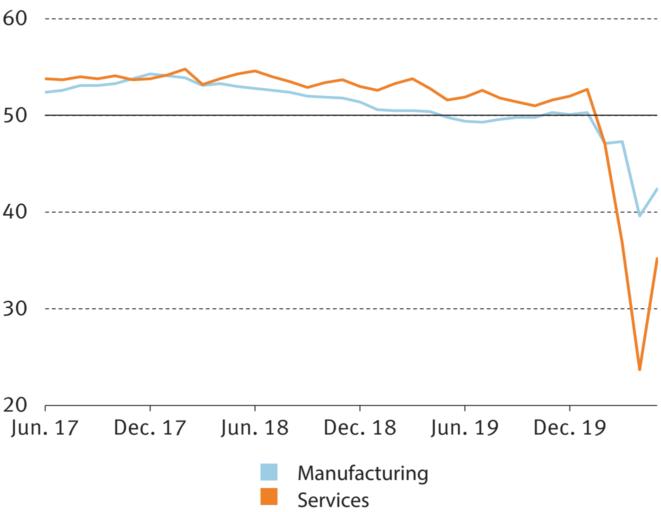


Financial markets defy this pandemic

Before the coronavirus cast its spell over financial markets at the end of February, all asset classes had started 2020 on the rise. Once the virus hit markets, investors reacted within a blink of an eye to de-risk portfolios. This drove global equities down 35%, creating the fastest stock market crash ever. Panic hit and investors fled for cash bringing all asset classes down. As with Newton's third law: "with every action, there is an equal and opposite reaction", stock markets rapidly bottomed. Upon news that central banks would do "whatever it takes", they started rising rapidly. The incredible injection of fiscal and monetary stimulus (see precedent Compass) fueled this recovery in financial markets (e.g. global equities recovered two thirds). Much in contrast with the still dire economic reality following the recent lockdowns.

Basic Trend 2:

Purchasing managers' indices (PMIs)

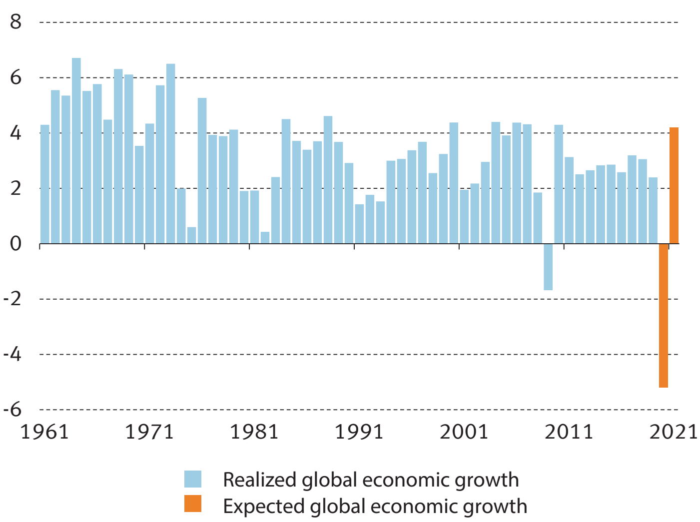


Purchasing managers' mood swings

Regardless of how financial markets recently recovered, the crisis is having a significant impact on the real economy. Future expectations about economic activity is gauged by looking at purchasing manager indices. In the manufacturing and service sectors, managers responsible for purchasing are surveyed on core variables. These core variables include the development of purchase prices, incoming orders and their stock. The purchasing managers' indices are calculated from all the answers. If the index is above 50, this indicates positive growth compared to the previous period. Over the course of the Corona crisis, the purchasing managers' indices literally collapsed. Although they are currently still below 50, the mood of purchasing managers seems to be brightening.

Basic Trend 3:

Global economic growth in % p. a.



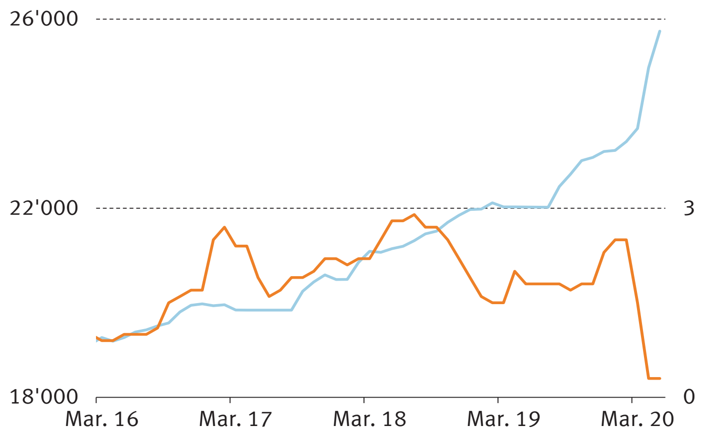
The real economy feeling the pain of lockdowns

As covid-19 spread globally, the short-term prospects for the world economy gloomed. The measures taken to contain the virus, such as stay at home policies and disruptions to supply chains led to a sharp decline in economic activity in the first half of the year. Although it should gradually return to normal with an easing of the containment measures, it is still too early to say when this will be the case. Nevertheless, global GDP is likely to contract throughout the year. The pace of recovery of the global economy will depend crucially on the combined effectiveness of health, fiscal and monetary policy measures.

Current Topic:
Long-term consequences of a pandemic

Current Topic 1:

US treasury public debt outstanding in bn. USD Inflation rate in % p. a.



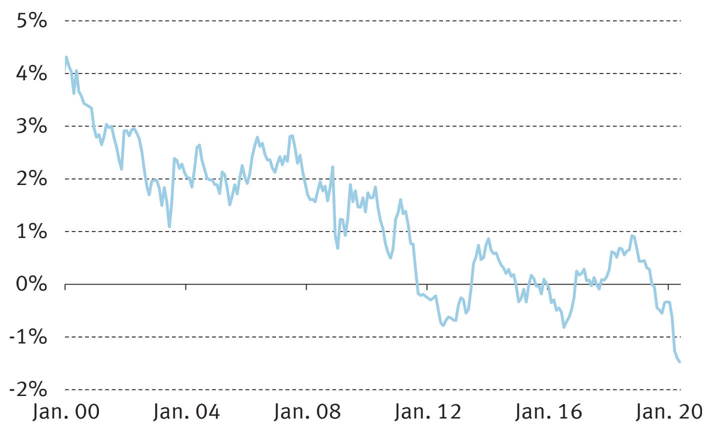
US treasury public debt outstanding in bn. USD (left-hand scale)
US inflation rate (CPI) (right-hand scale)

Public debt and inflation

The US government's response to the economic damage caused by the coronavirus is unprecedented. If the basic deficit (USD 1 tn), the approved (USD 2.2 tn + USD 0.5 tn) and planned economic stimulus packages (USD 2.2 tn) are summed up together, the US budget deficit for this year would increase to USD 5.7 tn. Such measures would bring the US debt to GDP ratio to 130% (+25%), of which a large proportion of the newly issued government bonds issued will be bought up by the US Federal Reserve through their asset-purchasing programme. These interventions by the Fed lower yields on government bonds and push equity prices up.

Current Topic 2:

US annualized real interest rate expectations 10 years ahead

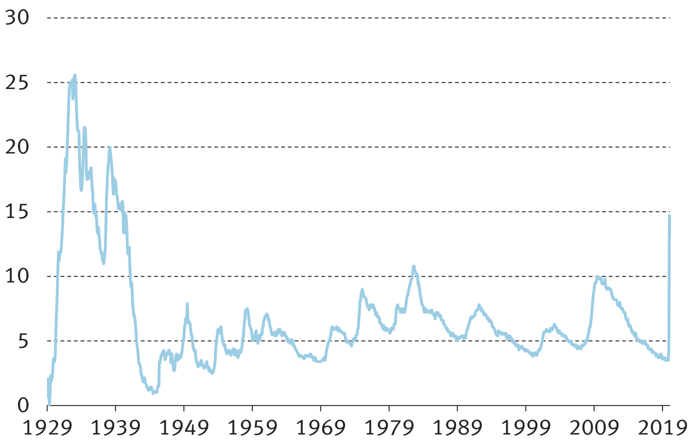


Real interest rate development after wars vs. pandemics

In order to predict the impact of pandemics on the economy, economists often compare it to wars or natural disasters. While the humanitarian consequences are possibly comparable, the economic reality is different. After wars, countries need to reconstruct, this increases the demand for capital and thus also raises interest rates. Pandemics on the other hand, do not require much reconstruction, but affect both supply and demand. The less the economy can produce, due to the prevailing uncertainty, the more is saved rather than consumed. This reduces the demand for capital further. Real interest rates, inflation-adjusted nominal interest rates, therefore fall in the long term, as illustrated by the chart.

Current Topic 3:

Unemployment rate in %



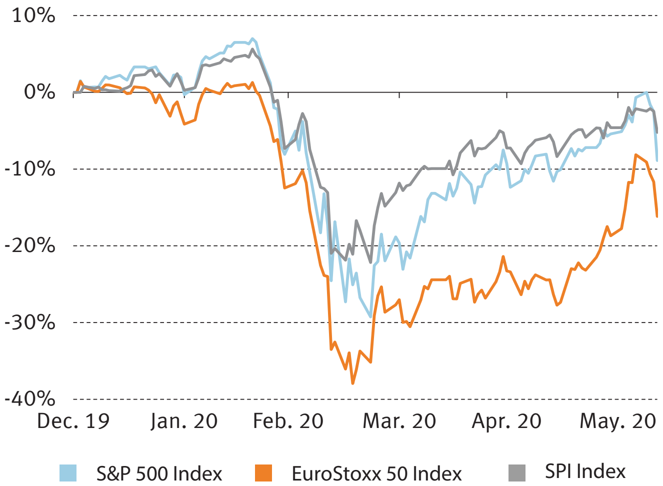
Explosion in unemployment figures in the US

Furlough as a job retention scheme has been praised as a very effective mechanism to avoid an economic meltdown during this pandemic. Unfortunately, the US does not have such measures in place. This is, among others, one of the reasons why US unemployment exploded (+10%) in April, to a level not seen since the Great Depression of 1930s. Such a sharp rise within one month is unprecedented. The government reacted by increasing unemployment benefits and hastily putting in place relief programmes for some key industries and SMEs. The latter contributed significantly to the surprising stabilisation of the unemployment rate in May. The long-term damage to the labour market can only be estimated when the relief programmes will come to an end and the economy is fully reopened.

Knowledge & Experience: Investment opportunities in times of pandemic

Knowledge & Experience 1:

Total return (net) in CHF



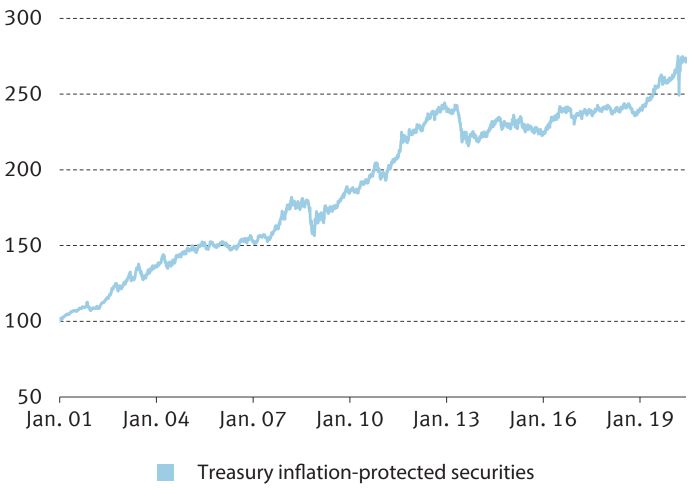
Monetary and fiscal policy drives share prices

Over the course of the corona crisis, global share prices have fallen (see Basic Trend 1). US equities recovered rapidly thanks to the high proportion of technology and healthcare stocks and the aggressive monetary and fiscal stimulus. In comparison, European stocks have lagged behind to date. The defensive Swiss stock index SPI lost significantly less than its competitors in the correction phase, but did not benefit quite as much in the recovery phase.

Since the beginning of the year, however, it has still posted the best performance of all three stock indices. In view of the high level of uncertainty and the associated large price fluctuations, we currently continue to recommend Swiss equities.

Knowledge & Experience 2:

Indexed performance in USD

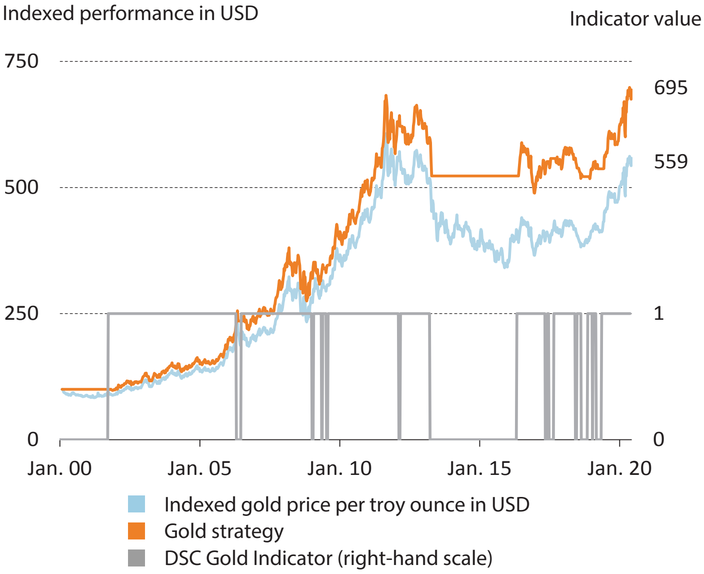


May we give you a TIP(p)?

Treasury Inflation-Protected Securities (TIPS) are a form of US government bonds that protect investors from inflation (when prices rise and money looses value). These bonds are backed by the U.S. government and pay investors a fixed interest rate, while the face value of the bond adjusts to the inflation rate. This means that when inflation rises, both the face value and the coupon increase, thus preserving the real purchasing power of the investment. If rising public debt (see Current Topic 1) leads to rising inflation rates, the attractiveness and value of these bonds should increase.

Knowledge & Experience 3:

Indexed performance in USD



At gold rate

Gold has always been regarded as a safe haven, providing stability to the portfolio during uncertain times. Aside from stability, it provides also additional advantages. Following the flood of liquidity from central banks, falling nominal interest rates and record high economic stimulus packages to combat the pandemic, inflation fears are on the rise. In addition, to TIPS, gold in particular serves a portfolio as a protection against a devaluation of money. A rising inflation rate causes real interest rates to fall, which in turn drives up the price of gold. Since the beginning of the year, gold is the best performing of all asset classes (see Basic Trend 1). Our gold indicator is still positive (value = 1) and signals a continuation of the current price trend.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

Dreyfus Sons & Co Ltd publishes Compass four times a year since June 2008. The publication is aimed at clients of the bank and interested parties. It describes some of the instruments and methods the bank uses to monitor everything to do with the financial markets. A description of the investment process can be obtained from your client advisers or our website. Compass provides guidance but cannot take the circumstances of an individual portfolio into account. It is for information and marketing purposes.

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